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(10:00 a.m.)

CHAIRMAN:

Q. Okay. So if there are no -

MS. GLYNN:

Q. There are no preliminary matters, Mr. Chair.

CHAIRMAN:

Q. Sir, I think we are with you.

KELLY, Q.C.:

Q. Thank you, Mr. Chairman. Mr. Chairman, Commissioners, Newfoundland Power has filed a comprehensive written brief which effectively addresses all of the issues in this proceeding. That includes both the settled issues reflected in the settlement agreement and the issues which were dealt with in the hearing itself, primarily cost of capital and depreciation. So I thought what might be helpful as we start this morning was to try to put this proceeding, and specifically the cost of capital discussion, into a bit of a broader long-term context, and in considering that historical context, I wanted to look back at where we've come from, but then more importantly, to discuss where we're going in the future because this GRA comes at an

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important time in terms of the future of the development of the Province's electrical system. We've just come through a major public policy debate about the future of energy supply here in Newfoundland and Labrador. The decision has been made to proceed with Muskrat Falls and the Labrador Infeed with power supply now projected for 2017 or shortly thereafter.

Deciding to build Muskrat Falls and bring power to the island is one thing, but much still needs to be done over the next few years to ensure that this new source of supply is properly integrated into the island grid. We must ensure that there is an uninterrupted and seamless energy supply for Newfoundland Power customers. And getting that right is important for our customers, but it's also important for the Province and the provincial economy.

Now Mr. Chairman, the principal issue in this proceeding is cost of capital and specifically the fair return on equity for Newfoundland Power. Mr. Ludlow, in his evidence, explained to you why having a fair

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return matters both to the company and to its customers and during the course of his explanation, he commented on the fact that we have a generally supportive regulatory environment here in Newfoundland and he pointed out some differences with other jurisdictions such as the automatic flow through of storm damage that's over $100,000 in Alberta, but we don't have that here. And that led to an interesting question from you, Mr. Chairman, in which you asked Mr. Ludlow "what else do you think we could do to make the regulatory environment more than generally supportive?" Now that was an excellent question and one that I think helps focus the discussion I'd like to have this morning.

Broadly speaking, from a financial perspective, two things are required in order to have least cost reliable power over the long term. One is appropriate capital expenditures and two is reasonable annual revenues, including the fair return, and you got to have both. Now with that comment, let's look back a bit and see how this has worked.

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You heard Mr. Ludlow describe the cuts to both operating and capital expenditures following the cod moratorium in 1992. Those cuts were unfortunate but necessary. We had 50,000 people leave the province and over time, those cuts affected the reliability of the electrical system. It's 1992.

Then we come up to 1997. We had first oil in the province from Hibernia. It was time to get ready for the future. And I've been at this now about 15 years and I remember being here listening to the then president, Mr. Hughes, talking about the need to get our electrical system ready for the changing economy. And I was here with Mr. John Evans, who was then the vice-president of operation and engineering, and we brought down examples of rusted out pole transformers, corroded conductor and defective insulators so the Board could actually see hands on what the actual state of some of these assets were. And the Board's own consultant confirmed what we were saying. And the Board responded by then approving increased capital expenditures to improve and maintain system reliability.

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That was the time when Newfoundland Power started to introduce the stainless steel transformer tanks that you heard about in this hearing in the last several weeks. And the Board has continued to support Newfoundland Power's capital program and today on our system we have good reliability, bearing in mind that we're on a rock in the North Atlantic.

But in addition to capital expenditures, you also need reasonable annual revenues, including a fair return on equity. And we brought Dr. Moran here in the late 1990s who explained to the Board that the least cost or the optimum cost is achieved when the return on equity and the capital structure results in an A bond rating. That gives you the least cost power over the long term. So, return and capital structure are both important components of getting least cost power.

In the 1998/99 GRA, the Board cut Newfoundland Power's return to what was then the very low rate of nine and a quarter percent. That was the lowest then allowed for any investor-owned utility in North America.

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And one of the credit rating agencies then reduced Newfoundland Power's credit rating. So we had this anomaly that just as capital expenditures were increasing, Newfoundland Power's credit rating was eroded. And as you know, money which is borrowed to fund capital expenditures has to be repaid over a 30-year period.

So in 2003, the Board changed course and increased Newfoundland Power's return to 9.75 percent. So the return on equity is a key component of least cost power for customers and of course, it goes without saying that the return matters to equity investors. They expect a return on equity which is equal to the return on other comparable risk investments or to put it slightly differently, returns which are comparable to those earned by other average risk utilities. And we know that capital flows to higher returns. That's the reason, for example, why FERC down in the United States is now giving higher returns for new transmission assets to encourage investment in those previously underfunded assets, the real problem in the US. And of

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course, one of the points out of that is management has an obligation then to both investors and to our customers to actually earn those returns. Earning the comparable return is what satisfies investors, satisfies the credit rating agencies and ensures least cost power. That's the point that Mr. Ludlow was trying to make in this opening comments.

So Mr. Chairman, if you then fast forward through the decade from about 1998 to 2008, we have a couple of things. During that period, the Board adopted a formula to adjust the ROE during a time when there was a long-term sustained decline in long Canada bond yields. Newfoundland Power actually proposed using the formula and the Board adopted that formula at that time over the objections of the then Consumer Advocate, who advocated regular cost of capital hearings. And the formula worked reasonably well until 2008.

The other thing that the Board did during that ten-year period was they expanded the range of rate of return. The rate is set at the midpoint of the range, but the Board expanded the allowed range. And that was done

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as an incentive for management to find productivity improvements between GRAs. That was in 2003. So the utility could increase its earned return in the short run, but of course, those savings flow back to customers for their benefit at the next GRA. So just like FERC in the United States, this Board concluded that an ROE incentive was a good thing, not just for the shareholders, but for our customers.

And then we come all the way up to 2008 and the world changed. The financial markets crashed. Long Canada bond yields collapsed. Credit spreads on utility bonds became astronomical. The formulas weren't working and many regulators at that stage, including the NEB and the British Columbia Utilities Commission, later followed by Alberta, suspended or discontinued use of their formula mechanisms. By the time we got to Newfoundland Power's 2009 GRA, things had settled down a bit, but there was still a huge degree of uncertainty in financial markets and where things were headed. You'll remember that the long Canada bond yields for 2010 were forecast to be in the four and a quarter to four and a half percent range, but at the time of the hearing in 2009, they were still below that range.

Newfoundland Power and its expert, Ms. McShane, pointed out the high degree of uncertainty in the financial markets and proposed discontinuing the use of the formula and simply setting a rate of return until markets returned to more normal conditions. But Dr. Booth, however, was confidently predicting that the worst was behind us; the recovery was well under way and long Canada bond yields would be five, five and a half, six percent within a few years. That's the discussion we had in 2009. In 2009, one thing we can say is the general consensus was that bond yields were going to be higher, not lower. And so that put this Board in a rather difficult position. You had to make a difficult choice and in 2009 you decided to do two things. One is you set the rate of return at nine percent and two, you decided to keep the formula.

Now those two things are not separate and

distinct. They are highly interrelated. At nine percent, the ROE for 2010 was approximately 30 basis points below the average of other Canadian allowed utilities, so 30 basis points lower than the average. But we recognized you can't just look at nine percent in isolation and we assumed the Board didn't do that either. If you're going to keep a formula, then you need to have some sense of well, what happens if I look out over the next couple of years with that formula mechanism. And at the time, of course, the Board was using a long Canada bond yield of four and a half percent for 2010 and if you took Dr. Booth's point where he was confidently predicting we could be at, say five and a half percent, then if you -- you had to set the rate of return at a fairly low rate to start off with, because look what happens if you didn't. If you were at nine percent and long Canada bond yields went up one percent, then Newfoundland Power's ROE in 2011 would have been 9.8 percent. And if you started at the average of Canadian utilities, 9.3, and it went up one percent, we would have

been over ten percent in 2011.

So the starting ROE and the formula mechanism, these two things are very interrelated and at that point in time, in 2009, everyone, including ourselves, were thinking ROEs -- sorry, long Canada bond yields would increase. And so that started us off in 2010 with a sub par ROE, below the Canadian average.

(10:15 a.m.)

Then just come through each of the years. We get into 2010 and the first thing that happens is we have the March ice storm and Hurricane Igor and with careful and prudent management and by deferring other expenditures, the company managed to absorb 1.8 million in costs without having to come back to the Board to ask for a cost deferral order. That's not a bad thing. That's a good thing. That's what you want your utility to do, if possible. And Mr. Ludlow did caution that that may not always be possible, especially if you get it happening late in the year and a cost deferral is necessary. Even Dr. Booth was complimentary about the

achievement and you may remember Mr. Ludlow rather proudly pointing out that our trucks headed home with the power back on passing the Canadian Armed Forces coming in to help, on their way in.

With good management in 2010, the company still managed to earn a return of 9.21 percent for 2010, which was close to the average of Canadian utilities. So that was 2010.

Then we come up to 2011 and the world did not unfold as we all thought it would. Long Canada bond yields fell dramatically. The formula cut Newfoundland Power's allowed ROE to 8.38 percent, the lowest for any investor-owned utility in North America in 2011. Credit rating agencies didn't reduce the company's bond rating, but they did flag up that the reduced credit metrics, as a result of the ROE reduction, and warned of a possible downgrade if they perceived a meaningful reduction in the level of regulatory support, combined with weaker liquidity and a sustained deterioration in Newfoundland Power's financial metrics. And clearly, the rating agencies were looking to see if this trend was

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going to continue and how it would play out.

As Ms. Perry explained, in 2011 the company chose to try to manage that problem, especially since there was a great deal of uncertainty because of the Bell pole -- Bell Aliant pole transaction and the related financial effects of that, including the rate base impacts that it had. So a great deal of executive time and effort went into managing the financial affairs of the company in 2011, including managing the return. The company did achieve nine percent, which was not a bad result in the circumstances, but as 2011 went on, the financial crisis in Europe became full blown, the US economy struggled, US and France got downgraded and long Canada bond yields collapsed, just went through the floor. Even Dr. Booth admitted he didn't see it coming.

Then if the formula would have applied in 2012, it would have reduced Newfoundland Power's return to 7.85 percent, far below any other allowed return. That led to another huge expenditure of time and effort to manage the return. There was a cost of capital application filed with the Board. Experts

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were hired. We answered hundreds of RFIs. And ultimately there was a negotiated return of 8.8 percent and that 8.8 percent stabilized Newfoundland Power's financial metrics. That's the word Moody's pointed out, used and pointed out in its most recent credit ratings report. But that 8.8 percent was still 28 basis points below the average of allowed Canadian utility returns for 2012 and you'll see that in an answer to a question by PUB staff at PUB-CA-023. And then we went through this 2013/14 GRA with more experts' reports and about a month of hearing time.

So Mr. Chairman, Commissioners, there's some important lessons we think to be learned from the experience of the last several years. It's important to keep in mind that Newfoundland Power is a small utility charged with providing electrical service in a harsh environment. For most of the past three years, Newfoundland Power's small management team has spent a large amount of its time and effort managing the company's financial affairs and its return because unless the company actually earns a reasonable return,

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everyone loses, shareholders and customers, because the allowed return is merely the starting point. The lower the allowed return, the harder it is to earn a fair return, one that's comparable to the returns earned by other average risk utilities. And as Mr. Ludlow pointed out, you may be able to defer some expenditures in the short term, but you can't do that without adverse consequences over the long term. That's particularly true in this jurisdiction when we already ask our utility to manage unexpected events such as storm damage, if possible, rather than providing an automatic storm recovery mechanism.

And that point is particularly important as we go forward because as I said at the beginning of my comments, the next several years are critical. Senior management needs to be focused on managing the electrical system, managing the transition from where we are today to where we must be in 2017-2018 and getting there requires a lot of work. Ultimately that new power generation source and those new transmission assets have got to

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feed seamlessly into Newfoundland Power's substations and its distribution system and that will require coordinated planning, implementation and execution by both Newfoundland Power and Newfoundland Hydro. Now that's the background.

So what is Newfoundland Power asking the Board to do now? We're asking you to do two things. One is to set a fair and reasonable return for Newfoundland Power, that's the first one, and two, discontinue the use of the automatic adjustment formula until we know what this new financial order is going to look like somewhere out in the future, at which time then the Board can reassess the appropriateness of a formula mechanism. And I'd like to talk about those two points.

The first, the fair return on equity. It's clear from the evidence that long Canada bond yields are now expected to be low for the next several years, through 2013, 2014 and 2015, so low in fact that Dr. Booth felt it necessary to put a floor of 3.80 percent in his proposed formula. That's 1.2, 1.3 percent above where long Canada bond yields are today

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and it's above where Dr. Booth expects them to be over the next several years. So there's no imperative for a formula. The Board can, it has the ability and so it can and should simply determine a fair and reasonable ROE which will be included in the test year costs until further order of the Board. That's essentially how the ROE was set and applied from the time the Public Utilities Act came into effect in the early 1950s all the way up to 1998 in this province.

In setting the return, the Board should be mindful that Newfoundland Power's allowed ROE's since the last GRA have been below par. That was especially true in 2011, but it was also true in 2010 and 2012. So the allowed returns for those years are not the appropriate benchmarks for the return that you should set today.

Now my friend, Mr. Johnson, the Consumer Advocate, will say that the cost of equity has come down and I'm sure he will say to you Ms. McShane said so. But it hasn't come down from nine percent. It's come down from what the real cost of capital was in 2010. If you look

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at allowed utility returns in Canada, the average was 9.29 percent in 2010. It was 9.08 percent in 2012 and you'll find that information in the response to the PUB staff question PUB-CA-023 and find it in Ms. McShane's Schedule 3, page two of two. And the evidence of the cost of capital witnesses was that the financial market conditions in 2013, 2014 will be no different than in 2012. You'll find Dr. Booth's answer saying that at PUB-CA-015.

But looking at allowed utility returns is admittedly circular, though it is a good reasonableness check. So what other things should you look at? Well, obviously the cost of capital evidence itself. Mr. Chairman, that evidence tells us that there have been two important shifts in regulatory thinking since we were here in 2009. The first is with respect to the use of the CAP-M methodology.

With the collapse of long Canada bond yields, which are driven by government monetary policy instead of market forces, there's no longer any clear and predictable relationship between long Canada bond yields

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on the one hand and a utility's cost of equity on the other. That's why regulators such as the British Columbia Utilities Commission, the Ontario Energy Board, the Alberta Utilities Commission, have moved away from sole or predominant reliance on the CAP-M methodology. They increasingly rely on other methodologies, in particular, the discounted cash flow or DCF methodology. The lack of any clear and predictable relationship between long Canada bond yields and a utility's cost of equity, for example, has forced Dr. Booth to make several judgmental adjustments to his CAP-M analysis as he tried to come up with a reasonable result and Mr. MacDonald acknowledged in his report that his CAP-M analysis on a stand-alone basis would result in a return which would not be a fair ROE for the company.

So the days of sole reliance on CAP-M are over. Dr. Vander Weide went so far as to say that its application is so distorted in current financial market conditions that he placed no weight on it. The use of multiple methodologies, each of which has its own

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strengths and weaknesses, is to be preferred. That was the approach of each of the other cost of capital witnesses, except Dr. Booth. That's how Ms. McShane approached it, Dr. Vander Weide approached it, Mr. MacDonald approached it. But even Dr. Booth did a DCF analysis. His DCF analysis yielded 8.73 percent which when combined with 50 basis points for floatation costs, would have given a DCF result of 9.23 percent and Dr. Booth himself acknowledged that he's now looking more closely at DCF results and previously what he used to do was apply 50 percent weightings to DCF and his CAP-M results.

Now the second change, because I told you I think there are two changes in regulatory thinking, the second change is with respect to US comparisons in determining the fair return. That's driven in part by increased reliance on the DCF methodology because it's not possible to construct a proxy group of Canadian utilities to apply the DCF model. There are only two publicly traded Canadian companies that you could use. It is possible, however, to construct a sample of US utilities, having comparable overall investment risk to Newfoundland Power. Each cost of capital witness did that, including Dr. Booth himself.

(10:30 a.m.)

Ms. McShane, you'll remember, explained in detail how she narrowed her criteria for the sample to satisfy the concerns that his Board expressed in its last order and Dr. Vander Weide and Mr. MacDonald each constructed their own samples of US proxy samples. And Dr. Booth's US sample included six utilities, all but one of which were in Ms. McShane's sample. So the testimony of all of the witnesses provides a strong evidentiary basis for the application of the DCF methodology to a proxy group of US utilities having overall comparable risk to that of Newfoundland Power.

In 2009, the National Energy Board expressly recognized that the integration of Canadian and US financial markets make US comparisons informative for determining a fair return and if you look at what British Columbia, Ontario and the Alberta Commissions have done in their last decisions, they now

all consider US-based DCF results in informing their views of appropriate returns for their utilities.

In Newfoundland Power's written memorandum, we have provided a useful table which summarize the ROE results of the various tests employed by each of the cost of capital witnesses and we did that as a useful assistance for the Board as a summary of all the evidence.

So with that, I'd like to turn to talk a little bit about the automatic adjustment formula and I've already said most of what needs to be said about that point. At this point in time, we believe the best approach is to discontinue the use of the formula until such time as we know what this new economic world order is going to look like. It is clear that for at least the next three years, we are going to be in a continuing period of low long Canada bond yields as a result of government monetary policy.

I do want to say that by proposing discontinuance of the formula, Newfoundland Power is not saying the Board should abandon a

formula for all time. The Board can reconsider the issue in the future. Over time, a regulatory consensus will emerge, but for the time being, simply setting a reasonable rate of return for Newfoundland Power is the best approach and then either Newfoundland Power or the Board can initiate a cost of capital review if market conditions change. That approach gets us out of the constant review of cost of capital that has occurred since the financial crisis in 2008 and which has occupied so much time and effort.

No witnesses come here, Mr. Chairman, to suggest that a formula is actually necessary. Dr. Booth testified that he only proposed a formula because he was asked to. And Mr. MacDonald agreed that one of the alternatives that the Board should consider is simply setting the rate of return with either party can come back and apply to change it, if needed. The two formulas proposed by Dr. Booth and Mr. MacDonald demonstrate the lack of any consensus as to how a formula should operate.

The two formulas can have diametrically opposite effects, depending upon the financial circumstances. With a floor under long Canada bond yields in Dr. Booth's formula, you could actually reduce Newfoundland Power's return if long Canada bond yields rise but utility spreads contract, because unless you get over his floor, even though long Canada bond yields go up, Newfoundland Power's return could go down because of the contraction of the credit spread. Mr. MacDonald's formula in those circumstances would yield the exact opposite result. And as Ms. Perry demonstrated, Mr. MacDonald's formula is unbalanced. A six basis point reduction in long Canada bond yields would reduce Newfoundland Power's ROE by a quarter of a percent, 25 basis points. While a 75 basis point increase in long Canada bond yields would result in no increase to Newfoundland Power's return. The proposed formula has a 23 basis point built-in downward bias because of how it's constructed.

The lack of a consensus over automatic adjustment formulas arises because there's no longer any clear and predictable relationship

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between long Canada bond yields and a utility's cost of equity. The attempts in this hearing to create a formula proxy for a utility's cost of equity have resulted in proposals which are complicated and uncertain. The proposed formulas not only incorporate utility bond credit spreads, but they've also added floors and deadbands and automatic triggers. There's no principal basis for us to conclude that such mechanisms will correctly establish the cost of equity for Newfoundland Power.

And it's interesting that the proposed formulas are each variations of or have similarities with the Ontario Energy Board's 2009 formula. Now the OEB needs a formula mechanism because of the very large number of small utilities that they regulate -- that it regulates. But that's not true in Newfoundland and Labrador. And it's interesting, proponents of formulas now suggest that the Ontario Energy Board formula is yielding reasonable results, but they ignore the fact that today's Ontario Energy Board formula results stem from the fact that

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the Ontario Board set the starting return at nine and three-quarters percent for 2010, one of the higher allowed ROEs in the country at that time. If you start high enough, yeah, it'll give you nice results now, but nobody was here at Newfoundland Power's last GRA, not the Consumer Advocate, recommending that this Board adopt an Ontario type formula starting at nine and three-quarters percent.

Most importantly, Mr. Chairman, at this point in time, it's important that Newfoundland Power's senior management team focus their time and energy on the Province's utility system. The certainty of a known return which is fair and reasonable is preferable to the uncertainty of what a formula may or may not do in a world of uncertain financial markets which are driven by government monetary policy rather than normal market forces.

So Newfoundland Power, as I said earlier, asks the Board to do two things: set a fair and reasonable return; and then, two, discontinue the use of the formula until it can be reconsidered at some future point in

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time.

Let me next say a few words about capital structure. Newfoundland Power's 45 percent equity component in its capital structure has repeatedly been affirmed by this Board. It is an important component of Newfoundland Power's overall average risk profile, bearing in mind the company's small size, hostile environment and relatively weak customer and employee demographics. Two additional considerations have emerged since 2008 supporting the need for the 45 percent equity in Newfoundland Power's capital structure.

The first is the fallout from the financial crisis. Other regulators, such as the British Columbia Utilities Commission and the Alberta Utilities Commission, have moved to strengthen their utilities' capital structures over the past several years. They've actually increased their equity ratios. And that, of course, was in line with the move to strengthen capital structures of financial institutions in the wake of the financial crisis because today, no country or business is immune from scrutiny by the credit

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rating agencies, more from a potential of a credit downgrade. We've seen that with the United States, France and most recently, Canadian banks. Mr. MacDonald specifically referred to the factor of the continuing fallout from the financial crisis in support of his recommendation to maintain Newfoundland Power's existing capital structure. That was in his testimony on January the 18th at pages 245 to 247.

The second factor was referred to by Mr. Ludlow in his evidence and interestingly, explicitly referred to by Moody's in their most recent credit report. Moody's expressed a cautionary note related to their concern that Newfoundland Power's future ability to fully recover costs and earn returns may be compromised as the Province of Newfoundland and Labrador undertakes development of the Muskrat Falls hydro-electric project on the Lower Churchill River and the related transmission infrastructure. That's the concern expressed by Moody's. And how credit rating agencies view Newfoundland Power's risk is obviously critical to maintaining

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Newfoundland Power's credit rating and ensuring least cost supply of power to customers.

And as I noted at the beginning of my comments, changes in credit ratings affect borrowing costs and the cost of power over the long term. Over the next several years, it's particularly important that credit ratings not be jeopardized. So at this critical juncture, it is important that the Board demonstrate its commitment to continued regulatory support. An ill-conceived precipitous move to reduce the equity component of Newfoundland Power's capital structure, as proposed by Dr. Booth, could well have serious adverse effects for the company, its customers and the Province.

The Board staff asked an interesting question of Dr. Booth in PUB-CA-015. They pointed out that Dr. Booth had not recommended a change in capital structure in his May 2012 report and they asked if there had been any change in capital market conditions since that time. And Dr. Booth confirmed that there had not been any such changes since his May 2012 capital structure recommendation, which was to

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leave it at 45 percent.

In addition, there are real and practical difficulties with the suggestion that common equity be replaced by preference shares, and I'm not going to go through them all. I simply note that as Ms. Perry explained, the only realistic way to reduce the equity component to 40 percent would be to borrow42 million dollars in additional debt. That would put significant downward pressure on Newfoundland Power's credit metrics at a time when Moody's is looking for those credit metrics to be stabilized. That's the word they use.

Finally, Mr. Chairman, on capital structure, a note of caution when you're reading the Consumer Advocate's brief. In his brief, the Consumer Advocate stated that Fortis had issued preferred shares in November 2012 at 3.8 percent. That rate is not correct. The correct yield was 4.75 percent. I think it's just a mistake. The Consumer Advocate put the correct yield to Ms. Perry in cross-examination and she confirmed 4. 75 percent. You'll find that, if necessary, in

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the transcript on January 15th, 2013, page 70, line 17.

So Mr. Chairman, Commissioners, those are my comments on cost of capital. I intend to say a few words on depreciation.

(10:45 a.m.)

It's demonstrably true that the Board made the correct decision in 1983 when it directed Newfoundland Power to use the equal life group or ELG depreciation procedure. That is clear beyond a doubt. ELG is a recognized sound public utility practice in Canada. It best matches the expense with the life of the utility assets. It also ensures the fulfilment of the power policy requirement of least cost power consistent with reliability over the long term. Customer rates today are 3.7 million dollars less annually because of the Board's decision to adopt ELG. That's because Newfoundland Power's rate base is 70 million dollars less than if we had stayed on the ALG, average life group, procedure. If we were to revert to ALG after a relatively short time period customer rates would again be higher because of the

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growth in the rate base. So that proposal is not in accordance with the power policy contained in the Electrical Power Control Act. Frankly, it is tantamount to saying let us take a benefit today that our parents paid for and let us pass the cost on to our children and our grandchildren.

The company's depreciation expense is reasonable and prudent. Of the seven mast property categories considered by Mr. Pous, Gannet Fleming had proposed increased in service lives for all of them. Their recommendation is supported by years of experience with Newfoundland Power's system, with site visits and with discussion with Newfoundland Power's engineering staff. Similarly, Gannet Fleming's recommendation with respect to net salvage estimate for overhead services is reasonable. There is simply no basis to conclude that any of the Gannet Fleming recommendations with respect to depreciation are either unreasonable or imprudent and that's the test that you would have to meet.

Mr. Chairman, Commissioners, next I want to address three points that the Consumer Advocate raised in his brief with respect to operating costs. Those are drug costs, retiring allowances and short term incentive pay. I'll be relatively brief on each of them and just ensuring that you have the appropriate references if you need to in the record.

The Consumer Advocate didn't call any evidence on these matters. The evidence in the record does not support his assertions and conclusions. Rather, the evidence demonstrates that each of these forecast costs is based upon the best information available. Grant Thornton conducted a comprehensive review of Newfoundland Power's operating costs, including these items, and found nothing unreasonable. There is no basis for the Board to conclude that any of these particular estimates of test year costs are unreasonable or imprudent.

First, on drug costs. The Consumer Advocate asserts that OPEB expense should be reduced because he speculates that drug costs will be less than forecast. There's no basis

in the evidence for that conclusion. The point was addressed by Ms. Perry in cross-examination. You'll find the evidence January 15th, page 133, line 3 and it carries through to page 141, line 13, and also on January 16 beginning at page 9, line 2, going through to page 17, line 23.

And succinctly summarized, Ms. Perry made the following observations: Newfoundland Power followed the usual process of forecasting drug costs based upon the health care trend numbers provided by Mercers. Mercers said the effect of the new drug regulation was impractical to quantify at this point in time. Overall drug costs depend not only on price but also drug usage. Further, Newfoundland Power already has pricing agreements with pharmacies through Blue Cross which provide better prices than current on drugs. And the forecast drug costs are based upon the best information currently available.

The Consumer Advocate's assertion that a six percent cost reduction will occur is unfounded speculation without any evidentiary basis. It is no basis for this Board to

conclude that the forecast expense is unreasonable and imprudent.

With respect to retiring allowances, the Consumer Advocate asserts that retiring allowances for new non-unionized employees should be disallowed. The point was addressed by Mr. Smith in cross-examination on January 25th, page 32, line 8 through page 48, line 6. Mr. Smith pointed out that retiring allowances had been part of Newfoundland Power's compensation package for many years, both for unionized and non-unionized employees. Newfoundland Power is currently addressing an important demographic transition in its workforce. He testified the company wants to hire better than average employees and to do so, must pay competitive compensation.

The Consumer Advocate's brief refers to proposed changes in New Brunswick and the Federal civil services. These developments were not introduced in evidence or explored during the hearing and they certainly do not represent any evidence, let alone any clear evidence, of changes in retiring allowances in Newfoundland and Labrador. But keep in mind,

retiring allowances are one part of a total compensation package. Changing any one component necessarily requires adjustment to other components to ensure that the total compensation package remains competitive and you must be competitive, especially in today's environment. So there is simply no basis to conclude that the test year estimate of costs for labour overall is unreasonable or imprudent.

And the third point is the STI or short term incentive plan. If I follow the brief correctly, the Consumer Advocate's primary focus appears to be with respect to the earnings related component of the short term incentive plan. His basis argument seems to be that earnings benefit shareholders not customers and I say in response, put simply, that's nonsense. As I discussed earlier, management has an obligation both to its shareholders and to its customers to work hard to earn comparable returns. Unless the utility actually earns a fair return, credit metrics deteriorate, bond ratings are jeopardized, borrowing costs potentially increase and customers suffer. The Electrical Power Control Act makes it clear that maintaining a sound credit rating is an important objective.

The Consumer Advocate called no evidence with respect to executive compensation. Executive compensation was fully explored in the last GRA and the Board accepted the expert testimony of Mr. Karl Aboud. In this hearing, the importance of earnings for customers was fully set out in the response to CA-NP-452. Mr. Ludlow dealt with it in his direct testimony and in his cross-examination. In his brief, the Consumer Advocate conveniently left out Mr. Ludlow's answer referring to the need for a balance between investors and customers. And Ms. Perry dealt with the testimony -- dealt with the issue in her testimony on January 15th, which you'll find at page 1, lines 18 through to page 6, line 16. And finally, in CA-NP-612, you'll see that STI earning incentives have been included in Newfoundland Power's cost of service since at least 1977.

The Consumer Advocate refers to decisions

from Alberta and the Northwest Territories. These weren't referred to or examined during the evidence, but you will note in CA-NP-612 that financial performance is a factor in executive compensation in British Columbia, Alberta, Prince Edward Island and of course, Newfoundland and Labrador.

But before I leave this, there's an interesting observation that Dr. Booth made and I'd like to take you to this. It's on January 18th, page 19, lines 8 to 19. And here's what Dr. Booth had to say about good management and earning the return. The question I put to him "but in order to earn the return, amongst the factors you mentioned is also good management?" and his answer "that's absolutely correct. If you look at this and you have hopelessly incompetent management that keeps making mistakes, then you would get unstable earnings and then you're in a paradox to then give the equity holders a higher rate of return because they hired incompetent managers." Dr. Booth obviously sees the paradox that results if management does not actually earn appropriate

returns. Earnings are important for both investors and customers.

Finally, Mr. Chairman, the last point I should touch on very briefly is the conservation plan. You'll note that the plan itself provides mechanisms for ongoing evaluation and consultation with industry and market participants, no new or additional process is required. Progress is being made with respect to conservation. This is an evolving program. The new program has an expanded portfolio of options for customers. But I want to make it clear, nothing limits the number of customers who may want to take advantage of the insulation option. That option remains open for existing homeowners, but the expanded portfolio gives customers additional opportunities to achieve savings on their electricity costs.

Mr. Chairman, Mr. Adams gave an interesting presentation with respect to mini-split heat pumps. Newfoundland Power personnel have spoken with Mr. Adams and will be following up with him further. Those heat pumps will be evaluated by the utilities. Mr.

Adams did note himself, he made a reference to Newfoundland Hydro doing an evaluation during his testimony. However, heat pumps have significant capital cost, as well as ongoing expense. So the cost benefit analysis must be considered over the long term and evaluated in light of energy supply costs and potential system savings. With a decision to proceed with Muskrat Falls, a hydro-electric project, a proper cost benefit analysis necessarily requires information on energy supply costs and the quantification of potential savings which is not currently available because potential savings will be different when the Holyrood thermal plant is effectively replaced by hydro power. However, Newfoundland Power and Newfoundland Hydro will be assessing this technology and its potential costs and system benefits as part of its continuing evaluation of conservation opportunities.

Mr. Chairman, Commissioners, those are my submissions and comments, unless you have any questions.

CHAIRMAN:

Q. So I guess we'll break for 15 minutes?

MS. GLYNN:
Q. 15 minutes, please, Mr. Chair.
CHAIRMAN:
Q. 15.
(BREAK - 10:59 a.m.)
(RESUME - 11:18 a.m.)
CHAIRMAN:
Q. So I think, Mr. Johnson, we're over to you, sir.
MR. JOHNSON:
Q. Thank you, Mr. Chairman, Commissioners. I recently reread the final argument that Mr. Kelly made on behalf of Newfoundland Power back in 2009 and at that time, he put certain propositions to the Board. He said that the propositions would be of considerable assistance to the Board in its deliberations on the cost of capital. The proposition at the time was that the cost of equity was going to be higher in 2010. He said it would be up, not down, and he said the position -- that proposition was really incontrovertible and he referred at the time to how the spread over the long Canada had risen to 275 basis points in the spring of 2009 at the time of the

company's last bond issue and he pointed out that though the bond spreads had fallen by the time of the hearing, it was clear that debt investors required increased returns relative to long Canada bond yields and he noted that with the cost of fully secured debt having increased, it was simply not logical to believe that the cost of the unsecured equity investment had fallen. He said that the share prices had dropped as a result of the economic turmoil and as the share prices fell, the dividend yield rose in relation to the share price. The equity markets were thus signalling, he said, a rising cost of equity, just as the bond market was signalling a rising cost of debt. The proposition, according to Mr. Kelly, was inescapable that the cost of equity in 2010 was going up.

Now given that this was such a key proposition last time, I would have expected Newfoundland Power to be now giving you, as its first inescapable proposition, the fact that the cost of equity is going to be lower in 2013 than what it is presently set at in rates in 2012. Because after all, the present

8.80 percent is not far off the nine percent order for 2010. And here we now have Canadian utilities, including members of the Fortis family, now borrowing 40 and sometimes 50 year debt at incredibly low interest rates. And as for the dividend yield, when Ms. McShane wrote her expert report in 2009, it stood at 4.2 percent. Now it's down to about three percent, evidencing a declining trend in the cost of equity.

As for the TSX price index, well, in March of 2009, just before Ms. McShane wrote her report, it was 7500 at its lowest, 8600 by the end of March. By October of 2009, when we were in hearings, the TSX price index stood at around 10,900. By July 2012, it was 11,600. By January 2013, it was 12,600.

Now the Board will recall in this case that Ms. McShane said that she prepared her 2009 report, and these are her words, "around the time of the worst part of the crisis." But she testified as well that things had changed considerably over the course of that year. She testified that by the time the hearing took place, there had been

considerable improvement in market conditions. But she admitted that these improvements were not reflected in her recommended ROE because her cost of equity tests were not sensitive to the changing conditions. That's the reason why there was no change in her recommendation.

Now in this case, Ms. McShane states that relative to late 2009, the cost of equity, according to the application of her various tests is 50 basis points lower. But you have to keep in mind that she is using pretty much the same tests in this GRA as she used the last time, albeit this time, we note that somehow she has managed to double the floatation allowance.

Now Mr. Kelly, in 2009, also provided the Board with a second proposition and the second proposition was that the maintenance of credit worthiness for Newfoundland Power required a return of between nine and a half and nine and three-quarters percent. Now they were seeking 11 percent, but between nine and a half and nine and three-quarters, he put that, that was the floor below which the company would not maintain credit worthiness and it would not be ensured that the company would be able to issue further debt to maintain service to its customers as required.

Now with all due respect, the evidence in this case clearly establishes that Newfoundland Power overstated the return on equity that it required to maintain credit worthiness and to ensure that the company was able to issue further debt to maintain service to its customers. They've had financial integrity ever since the last GRA and they didn't require nine and a half or nine and three-quarters to get that. Both Mr. Ludlow and Ms. Perry confirmed that the company has had financial integrity since the last general rate application. Keep in mind as well that the Board's financial consultant's report shows that even if Newfoundland Power received no rate relief in either 2013 and 2014, they would still be meeting their credit metrics.

Now this Board has heard from four witnesses on the cost of capital related issues and with due respect to each of the witnesses who testified, we submit that the witness who provided this Board with the most

in-depth analysis and explanation of capital market conditions was Dr. Booth.

Dr. Booth addresses the financial and economic outlook in his report as a first and foremost issue. He starts his discussion by considering the capital market conditions. He discusses the outlook for inflation. He looks at the recent history of the long Canada bond yield. He describes a situation with the Eurozone and the sovereign debt issues of the US. He addresses the wrangling in Congress about the debt ceiling and the heavy lifting that Congress left to the Fed and details the massive intervention of the Fed through the Operation Twist. He discusses how policy makers in most other major economies are looking for ways to stimulate their economies further amid the European debt crisis and he noted Governor Carney's recent comments that Canada is in a very different place. Dr. Booth quotes Governor Carney as stating that our economy is almost back at full capacity, that the labour market has been growing, that we're growing above trend and the extent to which we continue to grow above trend, we may

withdraw some of that monetary policy stimulus; that we have a financial system that's firing on all cylinders. That's the Governor's words and Dr. Booth refers to Governor Carney's statement that there are relatively few places in the advanced world that investors can put their money with a degree of certainty that something catastrophic is not going to happen. Canada is one of those countries.

Dr. Booth's report goes on to forecast the long Canada bond yield and he discusses the US situation and the fact that the United States has yet to take its fiscal medicine, as he puts it. He goes on to address the state of the corporate bond market and the state of capital markets generally. He refers specifically to the Federal Reserve of Kansas City and the financial stress index and he discusses how the researchers at the Bank of Canada who were actually the pioneers in developing a financial condition stress index, their index is reflecting relatively easy stress free capital market conditions.

He discusses the state of equity markets

during and after the financial crisis and how the state of the economy affects profits in the capital market. He discusses how profitability data has implications for the fair ROE. Dr. Booth concludes that the overall Canadian economy is in good shape and the financial system is firing at all cylinders. The stock market is valuing utilities favourably. Credit is easy. Utilities are issuing 40 and 50 year debt at very low rates. The only problem, as Dr. Booth puts it, is that as one of the very few AAA rated issuers left in the world, the Government of Canada is borrowing at extremely low interest rates, significantly lower than the US government. However this does not, according to Dr. Booth, indicate any heightened risk aversion in the credit markets.

Dr. Booth in full spends about 35 pages of his report bringing this Board through the state of the capital markets, and I will put it to you that it is Dr. Booth who can speak of these matters with the most authority in this proceeding. You can search high and you

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can search low in Dr. Vander Weide's report for discussion of capital market conditions, but you won't find it.

Ms. McShane discusses capital market conditions, but the thing with Ms. McShane is that she is so tied to her various tests that at the end of the day, her recommended ROE as we saw in 2009 is not really significantly influenced by the state of the capital market conditions. Ms. McShane tells us in her report called "Trends in Economic and Capital Market Conditions" that she is going to address trends and cost of capital since the oral portion of the 2010 GRA, but it is very clear that there is nothing that directly ties in with her estimates. Where, for example, do we see any discussion of how the collapse in the volatility or what she calls the fear index has caused her to reduce her market risk premium estimate? In fact, there is none, as she increases her market risk premium estimate, even as Canadian utilities access funds at incredibly low rates for incredibly long maturities.

Now once again, we have Newfoundland

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Power indicating that the Board should give greater weight to recommendations arrived at by the use of these multiple tests or multiple methodologies and we'll come to these methodologies shortly and how they've been applied, but we submit that it has not been established that the recommendation emanating from these tests are deserving of greater weight than Dr. Booth's recommendation. And to the contrary, it has been established, in our submission, that these other tests are not substantiated and we will get to that. But first to Dr. Booth's approach.

Dr. Booth says that the fair ROE is in the range of seven to eight percent with a midpoint of 7.5 percent on 40 percent common equity, which includes an 80 basis point adjustment for Operation Twist and a 40 basis point adjustment for credit spreads, for which he sets out the rationale in his testimony.

As Dr. Booth testified, the US Feds Operation Twist was intended to literally twist the yield curve and it worked. To the point that Dr. Booth does not regard the long term Canadian bond yield as representing a

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rate that is determined by ordinary investors, rather it's an interest rate that has been determined by the actions of the global policy maker. Just prior to Operation Twist, Dr. Booth testified that the Bank of Canada's June 2011 forecast for the long Canada bond yield was back to the four and a half to five percent range and he indicated that it would not be appropriate for Newfoundland Power to have a fair ROE determined by the actions of the Fed.

(11:30 a.m.)

Dr. Booth estimated the impact of Operation Twist by studying the yields on the TSX preferred share index which he regards as a distinctly Canadian investment because of its tax treatment and noted that the yields on the preferred share market did not come down to the same degree as on government and corporate bond yields following Operation Twist.

His credit spread adjustment, on the other hand, takes into account recent research at the Bank of Canada which looked at the causes of the change in spreads between

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corporate and government bond yields.

Now next we turn to the market risk premium. The Board is very familiar with the market risk premium. The Board in its 2009 GRA decision stated that "the equity risk premium test is for the most part based on Canadian data and while it is necessary to forecast for the future in assessing both the market risk premium and the beta, this is the sort of exercise that the Board is accustomed to in the context of prospective regulation." So this gets us into the whole question of what is the expected market risk premium for the market as a whole? We look at that before we look at the relative risk of a utility as compared to the market.

Dr. Booth's analysis and judgment is that the market risk premium is between five to six percent and his estimate in that regard is extremely well grounded. He considers Canadian capital market history going back to 1924 which points to a market risk premium under five percent, but he also gives weight to US data. He observes that the Canadian market risk premium has been about one percent lower than the United States, which has run about six percent. Dr. Booth also considers the results of an extensive survey by Professor Fernandez of some 7200 survey responses from financial analysts, companies and professors of finance, and this survey, which was published in June of 2012 shows that 2200 US respondents, they said that the average market risk premium estimate was about five and a half percent and for the 94 Canadian respondents, the average was about 5.4, right in line with Dr. Booth's estimate of the market risk premium.

By contrast, Ms. McShane has the market risk premium up at eight percent. Dr. Booth's estimate, we would submit is not only consistent with survey results, it is consistent with independent financial institutions, such as TD Economics, whose October 2012 report Dr. Booth refers to. Dr. Booth is also consistent with Mr. MacDonald who indicates that the market risk premium is in the range of five to six percent and whose report states that there was no evidence to support a risk premium outside that range and

he too cites Professor Fernandez' survey.

The other thing quite telling from the Fernandez study or survey is the direction of the market risk premium for the United States. The survey shows that estimates have it coming down over 2009, 2010, 2011 into 2012, descending from 6.4 percent in 2009 to five and a half percent in 2012. So Ms. McShane is not only high, Commissioners, she's going in the wrong direction. In her May 2009 Newfoundland Power report, which she was preparing in the immediate aftermath of the meltdown in the market, she had the market risk premium at 6.75 percent. Now she has it at eight percent. Ms. McShane's judgment does not pass the reasonableness test. Her judgment is not constrained by the facts in the capital markets.

Then we turn to the relative risk of a Canadian utility. Relative to the market as a whole, Dr. Booth says it's somewhere between 45 to 55 percent because these are low beta stocks. Mr. MacDonald is at .60, but Ms. McShane is up around .65 to .70 on the basis of the so-called Blume adjustment. I'd just

point out that regulators such as the National Energy Board in its TQM decision in 2009 did not accept the premise that these utility betas revert to one as the Blume adjustment is premised upon. Dr. Vander Weide is off the charts altogether at .73 to .92 for his beta estimate. As we say in our brief, Ms. McShane's estimate is vastly in excess of any beta range actually experienced by Canadian utilities in the past 20 years. Dr. Booth's evidence is that the Financial Post, Royal Bank of Canada, Google, Yahoo Finance, they don't adjust their beta estimates in the way assumed by these other witnesses. The Consumer Advocate recommends that the Board put most weight on the actual experience of Canadian utilities over the last 20 to 30 years because the fact is neither of the witnesses put forward by Newfoundland Power nor Mr. MacDonald have shown utility betas following the Blume adjustment process.

Now I'd like to say something about Dr. Booth's use of discounted cash flow method. He used to use that method regularly and he, today, regards it as one of the two

fundamental methods for determining the ROE. However, he said applying it to Canadian utilities is extremely problematic these days as there are not many Canadian utilities around and some of those who are around have large levels of unregulated operations. Neither Dr. Vander Weide nor Mr. MacDonald use DCF estimates on Canadian utilities. Dr. Booth has started to look at DCF estimates from both the United States and from the Standard and Poor's composite data for electric and gas utilities. However, he says given the substantive difference between the United States and Canadian markets and regulation, he regards these estimates as a check only and as he indicated before the BCUC, the estimates need to be reduced 90 to 100 basis points.

What is important to note is that Dr. Booth does use DCF methods to estimate the fair return for the capital market as a whole, which is an important element in anchoring his risk premium estimates. Dr. Booth points out in his Appendix D that he would judge the fair rate of return on the Canadian market as a

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whole to be 9.3 percent and the fair return on the US market to be between nine and a half to ten and a half percent, so higher in the United States than in Canada. He's also anchored in this regard by reports such as the TD Economics report.

Newfoundland Power makes the point in their brief that the use of long run geometric estimations of returns is not advocated by any expert in this proceeding. Well, first of all, it's important to point out that Dr. Booth referred to long run geometric returns, but also said an adjustment was needed and he said this repeatedly to make them arithmetic rather than compound returns. Newfoundland Power may not like it, but TD Economics puts the long run compound return for equities at seven percent, which when you convert to an arithmetic basis, is around nine percent.

Now I want to talk about the multiple test or multiple methodologies. First let me make this observation about Ms. McShane. Even if you accept her risk adjusted equity market premium test, which is derived from an outsized eight percent market risk premium and

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an outsized Blume adjustment beta, she still gets to 8.9 percent, and secondly, we find it rather interesting that she has actually doubled her financing floatation allowance from 50 basis points to a full one percent allowance. Ms. Perry had no knowledge of floatation costs doubling. We can only make the assumption that it's getting increasingly difficult for utility expert witnesses to attempt to justify the ROE recommendations that they are putting forward, which brings us to the historic utility analysis. This is what Dr. Vander Weide refers to as the ex poste risk premium and Mr. MacDonald calls the ERP.

For many years, as this Board heard, Ms. McShane admitted, indeed up to 2007, she would deduct the returns earned on bonds from the returns earned on stocks and that's how she would arrive at the historic utility risk premium. If she had used that approach, her historic utility cost of equity would have dropped from ten and a quarter percent to around 7.97 percent, and by the same procedure, Dr. Vander Weide's ex poste risk

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premium would have dropped -- result would have dropped from 9.9 percent to 7.69 percent and Mr. MacDonald's ERP would have dropped from ten and a quarter to eight. Mr. MacDonald, for his part, did not consider doing it in the returns for returns way, despite the fact that his report even had a reference to it being a returns from returns method. That line appeared in his report.

Now we have to keep in mind that the historic utility approach is supposed to be estimating what the go-forward utility equity risk premium is. As Ms. McShane's report says, it is supposed to be an indicator of what investors expect for the future based on the premise that over the long term investors expectations and their experience converge. Using the approach of Ms. McShane, Dr. Vander Weide and Mr. MacDonald, they are arriving at risk premiums of around 6.7 to 6.7 (sic) percent for a utility and using their approach, you have to arrive at the conclusion that utilities which have long been regarded as being safer than the average company would have warranted an addition 5.4 percent risk

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premium over the entire TSX over the period 1956 to 2011.

Now as came out during the hearing, this historic utility approach was advocated by Ms. McShane before the Alberta Utilities Commission in the relatively recent 2011 generic cost of capital proceeding and the Alberta Board agreed with the intervenors in that case that part of the reason for higher historical returns for the utilities over that period may be that allowed returns have been higher than the actual ROE that investors expected and required for investments of comparable risk. Therefore, the Alberta Commission found that the evidence on historic returns was inconclusive with respect to the return investors expect on comparable investments. Similarly, we submit that there is no reasonable basis for the Board to conclude that this method puts forward reliable evidence with respect to the return investors expect on a utility like Newfoundland Power.

Let me turn to a discussion of the discounted cash flow test. Putting aside for the moment the question whether the company has chosen to populate the samples of the witnesses are similar to Newfoundland Power, we have a more basic problem. It is clear from the estimation methods used by Ms. McShane, for instance, that the DCF estimate falls from simply using analyst's long growth estimates in the constant growth model to tapering them down to the long run growth in the economy at stage three and tapering them down again when you use the actual forecast ROE and financial parameters of the company that generates the future growth, which is the sustainable method.

This is a clear indication that not only are the short run analyst's growth estimates unreasonable methods for long run growth, but that using the long run GDP growth rate also overestimates a reasonable long run growth rate. So we ask a very simple question here. What evidence has been put forward by Newfoundland Power's witnesses or by Mr. MacDonald to substantiate that the companies they include in their samples of these very mature utilities have historically been able

to achieve dividend growth rates anywhere near what their forecast growth models are premised on. The answer, of course as we know, is that there is no evidence on the record to substantiate that either the Canadian or the US utilities were in fact able to achieve the GDP growth rate historically.

Now in Dr. Vander Weide's case, he doesn't use a multi-stage DCF model at all anyway, but the fact is that the multi-stage model produces lower ROE estimates than the constant growth model, precisely because analyst's forecasts used in the constant growth models, exceed forecast GDP growth. We asked Dr. Vander Weide specifically in the RFI process for data to substantiate whether his firms were able to achieve growth rates as put forward in the proceeding and he told us he didn't examine historical dividend growth data and he told me during the hearing to get the data and analyze it. They're publicly available.

Now this Board will recall, however, that we did find out from cross-examination of Ms. McShane that her sample of US companies from

the recent 2011 Alberta generic cost of capital proceeding were not able to achieve anything close to compound US GDP growth over the 20-year period from 1990 to 2010. Her US firms, which include several companies utilized by her in this proceeding, achieved only 2.7 percent average growth in dividends per share compared to the compound growth of GDP of 4.7 percent over that long period.

(11:45 a.m.)

And this is where Dr. Booth's concern comes in as he expressed it at the hearing. While conceptually DCF and risk premium models are equally valid, it's very important that any estimates of future growth for utilities reflect reasonable constraints because of the fact that these are slow growing mature companies. As he testified, that's one criticism that he has against some of the other evidence before this Board, "that none of the standard checks have been done." That's a professor of finance at one of the most well known universities in the country. We submit that there is optimism built in to these growth rates and we do not see evidence

in this case that investors believe optimistic forecasts. Similarly, the Alberta Board didn't believe there was investor -- that there was evidence that investors believe optimistic forecast.

As we stated in our brief, accordingly, in our submission, inadequate substantiation has been put forward by Newfoundland Power's cost of capital witnesses and by Mr. MacDonald to ground the Board's reliance upon DCF test results in this proceeding. Basing the fair return for Newfoundland Power on an analysis so lacking in substantiation is not reasonable.

This brings us to the companies themselves that were part of these witnesses' samples. As we said in our opening statement to the Board, Newfoundland Power has essentially doubled down on the American evidence in this case and it's just as deficient as it was in 2009. As this Board stated quite clearly in P.U. 43, in this type of analysis, it's not enough that the chosen comparables are the best available. If the data is to be relied on it must be shown to be a reasonable proxy of that reasonable adjustments can be made to account for the differences. In this case, as in 2009, the evidence is again overwhelming of a lack of balance as it is clear that on almost every measure, Newfoundland Power would have to be considered less risky than the US comparables. That essential fact has not changed, despite the manner in which Ms. McShane has repackaged the evidence. Dr. Vander Weide's samples are even worse. The majority of Ms. McShane's samples are from the 2009 case anyway. Of the six companies she dropped for not meeting her criteria, four of them are now in Dr. Vander Weide's sample, amongst others that are actually ranked by Standard and Poor's as among the very weakest rated utility companies in the whole of the United States.

Despite what Ms. McShane and Dr. Vander Weide say, Canada's business, as well as its regulatory environment, has consistently been seen as supportive relative to the United States. Newfoundland Power is a relatively low risk utility segment, being a transmission and distribution company. The only firm in

the samples of either Ms. McShane or Mr. MacDonald's sample that is truly a T&D company is Consolidated Edison. Newfoundland Power is a completely regulated company, no unregulated assets or earnings. As we detailed in our brief, a number of the companies used in the samples have significant levels of unregulated revenue from segments that are not protected from competition. Newfoundland Power's customer base is very favourable. It has no industrial customers and 87 percent of its total customers are residential, a point made explicitly by Newfoundland Power in its presentation to both DBRS and Moody's in February of 2011, which is found in Undertaking 10. They note as well that 85 percent of their commercial electricity sales are to customers in the service sector.

It is very clear as well that Newfoundland Power is relatively free of competition. Moody's refers to them as dominating the market which is geographically isolated and effectively protected from potential competition. Not so for the companies in Ms. McShane's and Mr. MacDonald's

samples, nor do several of the companies in the samples have the full extension of weather normalization protection that Newfoundland Power has. Newfoundland Power operates in a forward test year regime which is viewed as being the least risky. Dr. Vander Weide's July 2012 testimony in Missouri, which he tabled in response to an undertaking, said that the risk of regulatory lag can be addressed by regulators through, amongst other things, the establishment of forward looking test years. Quite a number of companies in these samples do not operate in forward test year jurisdictions. Regulatory lag is an issue in the United States, but it's not an issue at all for Newfoundland Power, according to Ms. Perry.

Finally, Newfoundland Power has very little earnings volatility. Ms. McShane admitted that if you have lower year-to-year return volatility, it may indicate that you've got lower short term risk. Dr. Booth's evidence clearly indicated that the 14 US integrated electric utilities that he looked at had significantly more earnings volatility

than Newfoundland Power. Newfoundland Power was by far the lowest with a standard deviation in its ROE of just .64 percent, whereas for the United States utilities, it ranged from 1.3 percent up to nearly eight percent and certain of these companies with higher volatility were in the samples of Ms. McShane and Mr. MacDonald and most of the 14 companies examined are in Dr. Vander Weide's comprehensive US utility group.

So as was the case in 2009, Newfoundland Power would have to be considered as less risky than the US samples on nearly every single measure and as Dr. Booth pointed out, even if you would consider these companies to be practically identical to Newfoundland Power, you would still have to make adjustments because of the United States situation. This goes beyond the companies. The issue for the Board to consider is whether there is sufficient evidence to support a finding that Canada's and the United States regulatory institutional economic and financial environments and their impact on the resulting opportunities for investors or for rate regulated companies are comparable.

We believe the evidence is very clear that you must make adjustments. As Dr. Booth notes, undeniably, long term bond yields are higher in the United States, at least 50 basis points higher than in Canada. He then says you look at the market risk premiums, historic evidence of the market risk premiums are of being higher in the United States, and you look at the Canadian utilities versus the US utilities. You can look at US evidence, but you have to make adjustments. Mr. MacDonald said the same thing.

Ms. McShane and Dr. Vander Weide are the only ones who don't believe you have to make adjustments, and in the case of Dr. Vander Weide, he essentially believes that American regulators have been getting it right and Canadian regulators have been getting it wrong for decades. As Dr. Booth puts it, everybody in Canada has somehow been having these very in-depth four or five day hearings in the cost of capital and somehow in Canada we've been getting it wrong for the last 15-20 years? Dr. Booth doesn't think that's credible for it

means that every regulator in Canada has been deficient in evaluating the evidence before them. We would ask the Board to reject that notion.

We are advocating, Dr. Booth is recommending, that the Board, for rate making purposes, reduce the common equity component in Newfoundland Power's capital structure to 40 percent and replace for rate making purposes the five percent common equity with preferred shares. This does not require intrusion into the company's actual decisions regarding the utilities capitalization as this Board clearly stated in P.U. 19 in 2003.

Newfoundland Power's capital structure with 45 percent common equity is higher than any other Fortis utility in the country and higher than Fortis Inc. itself. All the rest of the Fortis utilities are down around 40 percent and the parent company is down to something slightly less than 35 percent common equity. Dr. Booth's report addresses the fact that preferred shares, unlike bonds, are similar to equity and are paid out of after tax income and therefore support the credit

rating, as they do not add fixed interest costs.

As we point out in our brief, the reduction of the revenue requirement would have very, very modest impacts on interest coverage and cash flow to debt, a point we make at page 29. Newfoundland Power, in all due respect, is grasping at straws on this issue and they are setting up straw men arguments that they can knock down. We are not, and I want to make this perfectly clear, we're not suggesting that Fortis Inc. issue the preference shares and mirror them down to Newfoundland Power, nor is Dr. Booth suggesting, contrary to what Newfoundland Power's brief states, that they issue retractable preference shares either. They keep saying that issuing retractable preference shares as indicated by Dr. Booth would be effectively the same as issuing additional debt. But as we have pointed out at our brief on page 30, and as Newfoundland Power well knows, DBRS will typically treat preferred shares and hybrids as debt when the ratio of preferred equity and hybrids to

common equity exceeds 20 percent, but with Dr. Booth's recommendation, the ratio will not be 20 percent. It will only be 15 percent because we are adding five percent new preference shares on top of the one percent existing preference shares and the ratio of six percent to 40 percent common equity is only 15 percent, not 20. So that's a red herring.

Furthermore, Dr. Booth testified that it was ridiculous, as he put it, that preferred shares could not be placed through a private placement. He said it's the investment banker's job to go out and sell these securities and you give them a commission and these securities will be placed somewhere. So the request that we've made in our brief is for the Board to direct Newfoundland Power to go out, get two quotes from investment dealers as to the cost of such an issue for approval by the Board or alternatively, and in the interim, recommend for rate making purposes that Newfoundland Power be deemed to have issued five percent preferred dividend shares at the same cost as the recent November 2012 issue by Fortis.

We regard this step as replacing five percent common equity with preference shares as a very moderated approach. As Dr. Booth put it, a halfway house between going to the same ratios as other Fortis utilities which have up to 60 percent debt in their capital structure. We are not requesting that the Board replace five percent equity with debt. It would result in savings to customers and it would not impair Newfoundland Power's financial integrity. We believe it is a very reasoned and balanced approach to take, as it would not be adding fixed interest and therefore would be supportive of the credit rating and it would bring Newfoundland Power closer to being at par with its sister utilities.

Mr. MacDonald suggested that the capital structure is something that we should be constantly looking at and he expressed a concern about the sovereign debt crisis, particularly in the United States and he was looking at that in his determining that it was appropriate to maintain that at 45 percent

until we had clarity or some clarity on those issues. We would submit that Dr. Booth's evidence is to be preferred on this point. The macro economic conditions are not such as to continue to justify Newfoundland Power having 45 percent common equity when its sister utilities have 40 percent and they are subject to the same macro economic issues as Newfoundland Power. And keep in mind as well that Dr. Booth's proposal still gives Newfoundland Power pretty much the best capital structure across Canada, in terms of utilities.

Further, as we set out in our brief from the standpoint of business risk and financial risk, we submit that at the very most, Newfoundland Power has average business risk compared to other utilities. It certainly does not have above average risk compared to other utilities, that's for sure, in our submission. Although that was a point that Ms. Perry did not want to concede.

Over the past few years, Newfoundland Power's business risk, certainly in terms of its earnings volatility, has only improved

because of accounts like the OPEBs treatment and the OPEVA protections and it seems very clear, based upon definitions of financial risk that this Board has used in the past, as outlined in our brief, that Newfoundland Power has lower financial risk because of the 45 percent equity component than most other utilities in the country.

So, as Dr. Booth puts it in a passage that we have outlined in our brief at page 33, it's a logical conclusion that if Newfoundland Power is an average business risk utility and has lower financial risk, then it should have a lower allowed ROE than a benchmark Canadian utility or its common equity should be reduced. Dr. Booth indicated that he refrained from making a capital structure recommendation previously due to the state of capital markets. However, as he pointed out, as time passes and the markets heal, the need for such a high equity ratio passes. Newfoundland Power, in their brief, attempts to make hay from the fact that Dr. Booth didn't recommend a change in the capital structure in May of 2012. I would just point

out that it's very well known that 2012 was an interim arrangement for 2012 and there would be a full contested GRA, which is precisely the process that we're sitting in now.

Newfoundland Power, once again, wants to make light of the extensive cross-examination on risk differences between Canadian utilities, including differences between BC utilities and Newfoundland Power. And you'll recall that Newfoundland Power was similarly dismissive about cross-examination in its last GRA about the US utilities that Ms. McShane was referring to. But the key thing with this BC evidence is that this is Ms. McShane's own evidence that she spoke to only a month before she testified here and it's quite useful for putting the discussion around the risk that Newfoundland Power faces into a perspective for the Board. Ms. McShane's evidence in British Columbia was that generically, the lowest risk is electricity transmission, and of course, Newfoundland Power does have some transmission. Next would be electricity distribution, that would apply to Newfoundland Power. Higher in terms of risk would be

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natural gas distribution and the highest would be vertically integrated utilities.

(12:00)

Now in FEI in British Columbia, that's a natural gas distribution company. It's larger than Newfoundland Power. It's a heating load gas utility which has more exposure to declining throughput due to factors such as smaller and more energy efficient houses than electricity distributors. Unlike Newfoundland Power, which has a capture rate of around 90 percent in new residential units, FEI's capture rate in new multi-unit dwellings continues to be materially lower than in single family housing, only 30 percent in multi-unit where the trend is going in that market versus 70 percent in the single family housing units. Ms. McShane's evidence was that usage rates of new residential customers of FEI was 50 percent lower than that of existing customers. Natural gases share of the BC market is just under 50 percent, well lower than the share that natural gas enjoys in Ontario and in Alberta. Alberta, I believe, is up to 80 percent according to her

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evidence. Her evidence clearly displays that FEI is facing competitive pressures. They're facing provincial energy policies which are discouraging of the use of fossil fuels, and promoting the development and use of clean energy technologies and renewable resources. FEI is subject to a carbon tax on its natural gas. According to Ms. McShane in her own evidence, FEI's operating risk includes outages, gas leaks, severe weather, natural disasters, it operates in a remote and rugged terrain subject to damage from a variety of natural events, including avalanches, landslides, fires. So Newfoundland Power is not alone when it comes to challenging operating environments, and all the while Ms. McShane says that FEI's regulatory risk is increasing and it's increasingly involving regulatory lag and uncertainty that stems from the changing energy environment. Ms. McShane, however, would only concede that FEI is of "somewhat higher fundamental business risk than Newfoundland Power". She says she would consider them relatively similar if you consider the size issue. We do not accept the

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argument that Newfoundland Power's size erases all of the advantages that Newfoundland Power enjoys by way of these other business risk indicia, whether it is belonging in a low risk T & D sector, to its being market dominant, to its having little competition. There is no objective evidence that Newfoundland Power is required to have 45 percent common equity to be an average risk Canadian utility. We were very struck in this hearing when our learned friend, Ms. Greene, Q.C. asked Ms. McShane to name a Canadian utility with a lower risk than Newfoundland Power. You will recall that there was an extended silence. The only one that she could come up with as Altalink, which she said would have a lower business risk, and that's been reflected in a lower common equity ratio by the Alberta Utilities Commission, but even then she qualified it by saying, I'm not sure when you look at it on an overall basis it's necessarily that much lower risk. It's pretty telling when the company's main capital witness couldn't think of a utility in Canada with lower risk than Newfoundland Power. Now finally, I would like to address something

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that I never addressed in my brief, but it was a contention of Ms. McShane that her recommendation for the fair ROE would increase by about 50 basis points if the common equity component was lowered by 5 percent. We would urge great caution here. In our respectful submission, the Board would only adjust the ROE if the Board found that Newfoundland Power is an average risk utility and their capital structure is more aggressive than the average. That is to say that if the average common equity for a firm like Newfoundland Power was 40 percent, and the Board gave Newfoundland Power 35 percent like Fortis uses, then you would adjust the ROE. However, in this case, we are simply moving an average risk utility to the average common equity ratio and recommending an average ROE. I would urge caution as well in Mr. Kelly's reference to Schedule 3 to Ms. McShane's Report of allowed ROEs. Those allowed ROEs include ROEs from companies that are like PNG and Nova Scotia Power, which Ms. McShane puts at being the highest risk in the country. We end this capital structure discussion by stating to you that there's no objective evidence that Newfoundland Power requires 45 percent common equity to be an average risk Canadian utility. Dr. Booth's preference share proposal represents a balanced and reasonable approach to lowering Newfoundland Power's common equity ratio for rate making purposes. As regards the weight of expert cost of capital evidence, we submit that the evidence of Dr. Booth is entitled to the greatest weight before the Board. His evidence is clearly more tied to the circumstances of the capital markets. Neither Dr. Vander Weide or Mr. MacDonald discussed in any substantive fashion the capital markets. With Ms. McShane, there is nothing that directly ties in with her estimates. To a great extent, her estimates are detached from the general capital market discussion. Were she to more accurately incorporate her discussion of capital market conditions into her testimony, it would lead inevitably to a lowering of her fair ROE recommendation. Dr. Booth, in contrast, is the only witness that has substantively looked at the development of capital market

conditions since 2008, both in terms of the credit risk adjustment he used, and his recognition of the impact of the US operation "Twist". In assessing the weight to be given to the witnesses, we would urge that the Board look at the actual details by which they arrive at their recommendations, not just the recommendations alone. The DCF based equity risk premium test carried out by Ms. McShane and Dr. Vander Weide, as we outlined in our brief at page 26, showed dramatic decreases in the DCF cost of equity from 2009 to 2012. In Ms. McShane's case, 180 basis point drop. Dr. Vander Weide's case, 190 basis point drop since this Board heard the evidence in the last Newfoundland Power GRA, and 320 basis points down from March, 2009, relative to where they stood in June, 2012. We ask the Board not to permit new and inventive ways of carrying out the historic utility premium test or inventiveness in relation to the financing flow station costs to distract you from this fact. Keep in mind as well that the historic utility method, however these witnesses have labelled it, is not representative of the go

forward risk premium for Canadian utility. Recall as well that the DCF tests are not backed up by substantiation. Consider whose recommendations for the fair ROE is actually tethered to the real world. Consider the indications from TD Economics, Royal Bank of Canada. These institutions are independent. We would urge you to reflect on whether it truly constitutes good judgment to come before the Board, as the utility witnesses have done, and tell you that what is at worst an average risk Canadian utility like Newfoundland Power should be awarded 10.5 percent on its common equity. Consider what that would mean in the context of people who are saving for their own retirements, or the returns that are being achieved in pension plans. Does that constitute judgment constrained by facts? Seemingly, these witnesses wish for us to forget the outside world when we enter this room, and park commonsense out by the door. And least it should be considered that Dr. Booth, who would put the return between 7 and 8 percent at 7.5 is a low ball estimator, consider Dr. Booth's evidence that every

utility in Canada has got a market to book ratio of about 1.4 to 1.8 percent, as he stated. It means, as he put it, that investors are very, very happy with allowed ROEs in Canada. We submit that Dr. Booth's evidence is clearly the most deserving of the weight to be given by the Board. In relation to the automatic adjustment formula, both the Board's staff witness, Mr. MacDonald, and Dr. Booth, recommended a formula. The consumer advocate supports the recommendation of Dr. Booth's automatic adjustment formula. Dr. Booth's addition of a 50 percent adjustment for credit spreads has been accepted by the Regie and the OEB. In this, he and Mr. MacDonald are in agreement, as was Ms. McShane previously before the NEB, and the Regie. So there is consensus on that point. This Board has a long history of using the formula and we regard Dr. Booth's recommendation as regards adjustment to changes in long Canada bond yields as reasonable, and in line with the Board's historical adjustment mechanism. Dr. Booth's evidence was that a 50 percent change is recommended by Mr. MacDonald and by Ms.

McShane in the Regie case violated basic economic assumptions and was rejected by the Regie, who adopted Dr. Booth's 75 percent change. Dr. Booth testified that the adjustment factor would provide consistency with prior decisions of the Board as interest rates revert to normal. The consumer advocate recommends Dr. Booth's approach to deal with the current situation of exceptionally low interest rates. Dr. Booth recommends a floor for the long Canada bond yield forecast to be set at 3.8 percent. This ensures that unless the long Canada bond yield substantially increases and moves back to normal range, there is no change in the allowed ROE. As regards operating cost, the impact of new provincial regulations regarding generic drugs, we deal with this, of course, in our brief at page 38 and 39. We submit that the revenue requirement of Newfoundland Power should reflect some cost savings arising from the passage of this legislation. Section 5 of the legislation mandates that the price for a product listed in the formulary shall not exceed 40 percent of the brand price, and this

applies for the period from October 1st, 2012, to March 31st, 2013, but from April 1st, 2013 onward, the product shall not exceed 35 percent of the brand price. The bottom line is that the savings or potential savings from the regulation are not reflected in the 2013 and 2014 test year, OPEB's expense. The company's actuary simply uses historical data to extrapolate forward for the purposes of accounting. So obviously an extrapolation of historical data could not reflect the downward impact of the legislated reduction in generic drug costs, and while the Mercer approach is standard for financial reporting purposes, it's not meant to be a forecast that would meet accepted standards for determining forecast for a test year that should be recovered in the customer's rates. So our proposition is that the forecast of costs that are included in the rates should reflect all known cost drivers that will result in higher, or in this case, what we believe to be lower rates than are derived by simply extrapolating past costs. We believe that that will be a fairer way to go than assuming that the impact

of the legislation would be zero. We have attempted and it's only an attempt, to make a better forecast than assuming, as the company did, that there would be absolutely no impact. We base that off the admitted fact that about 60 percent of the plan is geared toward generic drugs, and the evidence from Ms. Perry indicated that Blue Cross provided that the impact on at least certain drugs could be as high as 20 percent. So we put forward as a more reasonable assumption, an assumption of a 6 percent reduction in OPEB's expense rather than a zero percent impact, and the 6 percent figure is arrived at by assuming « of the as high as 20 percent impact, so 10 percent, and assuming - and applying that savings to 60 percent of the total expense, which is the portion that relates that generic drugs. It's imperfect, perhaps imprecise, but better than assuming no cost reduction, and obviously, as we point out, these regulations were designed to benefit everyone who must pay for the generic drugs, and, therefore, the only way to pass the benefit on through the rate payers in a timely manner is to adjust the OPEB's

expense as included in rates for 2013 and 2014, and to the extent that it's a mis-estimate, the OPEBDA will ensure the actual cost will be ultimately passed on to customers. I turn now to the retirement allowances. Customers of Newfoundland Power have a right to expect that the management and operation of the company is carried out at the lowest possible cost consistent with the provision of safe, reliable service. Newfoundland Power, as a matter of course, offers costly retirement allowance benefits to new hires. In the case of a new unionized employee, that's a matter of a collective agreement that's presently in force. So that remains an extant obligation. However, there is no extant obligation to continue to offer retirement allowances to new hires who join the non-unionized ranks of Newfoundland Power. There's absolutely no doubt that Newfoundland Power is a well regarded, well sought after employer, as was clear through the cross-examination of Mr. Smith. Newfoundland Power receives multitudes of qualified applications from prospective employees whenever it issues

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a public advertisement for a position at the company, but the fact is with the coming demographic changes in the workforce at Newfoundland Power, customers should not have to bear the cost of retirement allowances for these new hires. This retirement allowance entitles the new employee hired today to receive approximately a half a year's salary when he or she retires in the future in the normal course. That is an avoidable and unnecessary expense, and I don't think that my learned friend would dispute the fact that there has been movement in that regard by the Federal Government, the RCMP, and those institutions. So what we say is that this is a avoidable and unnecessary expense, and this is the time to bring reform to the issue. As the evidence discloses, by 2017, employees with less than 10 years of service will be making up approximately 45 percent of the workforce, and as we point out and provide specific examples of, there's a growing trend away from the payment of retirement allowances. As you will note from the materials filed, we talk about New Brunswick,

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we talk about the Federal Government.

(12:15 P.M.)

Now you may recall in the last GRA that there was to'ing and fro'ing that we had to do with Newfoundland Power over the fact that they were providing free health care benefits to retirees, something that Hydro and other institutions were not doing. Newfoundland Power did not want to introduce reforms, but eventually they did and the reforms were rather modest because they made no changes to the plan for any existing retirees, and they made no changes for employees who retire or who are eligible to retire before December 31st, 2012, but what they did do is bring in a 50 percent member pay cost sharing arrangement for retirees over the age of 65, not including those groups I just mentioned who were exempted. The company reports, and it's on the record in CANP-504, that the cost savings of these amendments to Newfoundland Power's OPEBs plan are reflected in the decrease in the accrued OPEB's obligation of 15.2 million dollars, and they state that the decrease in the OPEBs obligation serves to decrease future

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OPEBs expense. This is precisely what we want to see in relation to these retirement allowances. At this time, the consumer advocate submits that the revenue requirement for 2013 and 2014 should not include any recognition of future retirement benefit costs in the form of retirement allowances for non-unionized employees who commence employment with Newfoundland Power during the test years 2013 and 2014 or beyond. As regards executive compensation and the short term incentive aspect of it, in a nutshell, what we're submitting is that the revenue requirement for 2013 and 2014 should not include the portion of the short term incentive pay for executives or managers resulting from the achievement of targets relating to earnings. Achievement of the 34 million or 35 million or 40 million dollars in earnings which will get paid out to dividends to the shareholders of Newfoundland Power is clearly for the primary benefit of shareholders, and not for the primary benefit of rate payers, and we address this issue in detail in our brief. In our submission, short term incentive targets for things like

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reliability, customer satisfaction, injury frequency rates, controllable operating costs for customers, these fall into a separate category, as these are performance measures which, if achieved, provide direct benefits to the rate payers. We submit that the same does not hold true for an earnings target. We have provided in our brief references to the approach on this matter by other Canadian regulatory boards. The Northwest Territory Board, for instance, held in a 2007 decision that the portion of the utilities at risk compensation program that was based on net income targets should be borne by shareholders, not rate payers. We reference as well the Ontario Distribution Rate Book from 2006, which indicated and stated that incentive payments related to benefits to shareholders would not be recoverable in the 2006 revenue requirement, and we provided as well a decision concerning the EUB and it was then known in Alberta, which denied ATCO Electric's inclusion of a portion of its variable pay plan which was focused on financial returns. The Board held in the

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Alberta case that it was not appropriate to fund the portion of the variable pay plan that had been set up for 15 senior employees through rates where the benefit of the variable pay plan primarily provided an increased return to the utility. We do not regard the present case involving Newfoundland Power's compensation targets being tied to earnings, as truly being distinguishable from the regulatory precedents that we put before you. Accordingly, we would urge the Board to not permit this portion of the STI for Newfoundland Power's executives or managers to be included in revenue requirement for the test years. In relation to the conservation plan, we discussed the conservation plan at pages 48 to 51 in our brief. We recognize that the new five year plan jointly prepared by Newfoundland Power and Hydro is a very recent document tabled only in this GRA proceedings. Pursuant to those initiatives described in the plan, Newfoundland Power is forecasting increasing spending in the area over 2013 and 2014 over spending levels previously. Our overall recommendation at

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this stage is, I believe, a fairly practical one in the sense that we cannot really have a complete discussion about the merits and shortfalls and criticisms, and areas of improvement that may arise from this plan in the absence of Newfoundland and Labrador Hydro, where this is, after all, a joint plan. At this stage, I'm not prepared to be condemnatory, nor completely congratulatory because I think, frankly, it would be premature because I believe that the plan needs to be considered in a proper framework which allows for proper examination. I will state, however, that greater emphasis is being placed on energy conservation, and I acknowledge that the utilities report growing participation in the programs, and certainly, as I think we all know, the publicity around the Take Charge Program has been pretty widespread. On the downside, I am concerned that the programs which have been shown to be providing a very good bang for the buck in terms of the energy savings and the impact on customer's individual bills, such as the insulation program which, in fact, has

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resulted in the highest amount of energy savings of all the programs, is not being further intensified, now particularly that the new housing stock is being taken care of without the need for incentives because of the building code requirements, and frankly, I view this as problematic when we have 96 percent when we might as well say 100 percent of electricity customers indicating that their primary motivation for trying to cut back on electricity use is to save money, and the significantly increased level of spending on the small technologies portfolio, such as the CFLs, the LED lighting, and the Energy Star appliances will not do as much to benefit a heating customer in terms of a bill impact such as the insulation of a basement or an attic would. So frankly, I'm submitting that it will be necessary to examine how well the program portfolio is aligning with the view of those electricity customers who want to save money by lowering their bills. So I question the insulation for that matter, the windows piece for the existing housing stock, and I think the review should look at the benefits

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and costs that would arise from more aggressive targeting of that segment. In that regard, I would submit that not only Newfoundland Power, but Newfoundland Hydro, should have actual targets in place in terms of the number of customers they're trying to reach with the respective offerings. At the present time there are no targets established at Newfoundland Power to reach any particular number of customers in relation to the programs that they offer. We submit that this should be part of the review of the recent five year plan. I would subscribe to the adage that "if you measure it, you will manage it". I refer as well to Mr. Adams testimony before the Board, in which he provided a detailed presentation and brought forward a series of recommendations. His conclusions included that the program is inappropriately funded and that the measures had no meaningful impact for electricity customers. He concluded that the plan does little to reduce system feed loads, amongst other concerns. His evidence with respect to the potential energy in peak savings that could arise from air sealing homes and through the use of ductless heat pumps was quite detailed. The technology which he described has been available, according to Mr. Adams, for about eight years in this province, and according to Mr. Adams has shown quite a level of success in studies in certain jurisdictions in the United States, and he also, of course, described a pilot study which he was involved in in this jurisdiction, and though it was informal, it was still persuasive. It says to me that the potential for this technology to be incented on a cost effective basis should definitely be formally and professionally assessed. Therefore, what we are recommending to the Board is that the Board initiate a process, in consultation with both utilities and the consumer advocate, that would allow an appropriate review of the plan involving interested parties and to allow an opportunity for input. Turning to depreciation, in our brief we outlined that the precision of estimates required with the ELG, and we point out the inability to predict the future in terms of retirements and it produces a greater

degree of error for ELG over ALG. Mr. Pous states that, "when the variance between future estimates and actual future events happens, and corrective action is taken, the ELG magnifies the degree of error that has to be corrected". Mr. Pous stated that this is significant, given that the utility industry has historically lengthened the expected average service life of investments in the accounts. We submit that this position has not truly been refuted on the record at this proceeding. As regards time sensitivity, Mr. Pous testified quite clearly as to the real life reasons why the ELG calculation procedure is more time sensitive than the ALG procedure, and in that regard, we would refer you in your deliberations to page 55 of our brief. We submit respectfully that this position likewise has not been truly refuted by Newfoundland Power or Mr. Wiedmayer. Mr. Wiedmayer attempts to address the time sensitivity problem by saying that utility property is constantly being added and retired, but the plant additions and retirements, as Mr. Pous says, do not occur in

a precise or even close to precise pattern that would retain the appropriate relationship developed for ELG annual vintage rates on an annual basis. So we submit that Mr. Wiedmayer has not effectively refuted that criticism that Mr. Pous has put forward as regards to time sensitivity issue. No one disputes that the reason we pay less in depreciation expense today is because depreciation expense for Newfoundland Power has historically been higher since 1978 under ELG depreciation than it would be had ALG rates been used. Precisely because customers paid more in the past, we pay less today. Newfoundland Power says 3.7 million dollars less in 2014, but, of course, that's based on a 10.4 percent return on common equity for 2014, but logically if you pay faster or you pay higher amounts in earlier years, you're going to pay lower amounts in later years. Mr. Wiedmayer himself acknowledged that under the ELG procedure, depreciation accruals may be higher in earlier periods and lower in later periods. Mr. Pous, for his part, states it's not a "may" proposition, it's a "will be" higher in

earlier period situation. Mr. Wiedmayer referred to Mr. Pous' proposal to use ALG depreciation rates as only resulting in a narrow short term benefit, and he stated, "The temptation to reduce depreciation expense in the short term must be weighed against the full impact of the proposal". He stated, "From the perspective of inter-generational equity, it's not a proper practice to provide a short term benefit to current customers at the expense of all others". You will recall the discussion with Mr. Wiedmayer about the short term nature of what he termed the "benefit". We're not talking about a short term situation here. I think that's important to consider. We are talking about taking more than 11 to 15 years to reach the point where customers would be paying the amount that Mr. Pous has stated that they should have been paying all along. Mr. Wiedmayer says that this 11 to 15 year period was longer than what he had originally thought. He said in his evidence, "Sometimes when I've done that calculation, the crossover occurs somewhere in the seven year time frame", and that 11 to 15

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year time frame only gets longer if Newfoundland Power is awarded less than 10. percent on its ROE, but already at 11 to 15 years we're talking out to 2024 to 2028. We advocate ALG not because we have succumbed to a temptation. We advocate ALG as the method by which the vast majority of customers in North America have their depreciation expenses determined, and a method that does not result in a situation where depreciation accruals are higher in earlier periods and lower in later periods, and a method, in our respectful submission, that is more aligned with the reality of how depreciation actually gets implemented in the utility industry, and in rate cases.

(12:30 P.M.)

Now I fully appreciate the technical nature of the depreciation debate, and as anybody who was here, and perhaps it can be said had to endure some of the discussion about the accounts, it's slow going stuff, and I'm not going to proceed to go through each of these accounts with you. I think you've suffered enough. I just want to leave with you a

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couple of key observations as regards the Board's determinations on these accounts. We submit, first of all, that the Board shouldn't give Newfoundland Power's depreciation expert an automatic pass on the accounts because of his relationship with Newfoundland Power and the fact that he's met with the company personnel. We would urge you to look at the evidence on each of the accounts and to see if it stands up to scrutiny. Where you find Mr. Pous is all wet, I'm sure you'll say where he's all wet, but where Mr. Pous is saying, look, this is an account that was largely based upon an analysis of the actuarial data, we would suggest that you weigh the arguments back and forth on the analysis in an even manner. That's all I can really ask of you, and I'm not going to further go into the particulars, and I have set out those general observations in my Brief. I guess to conclude my comments, I'd like to acknowledge the Board and the Board staff throughout the proceeding, acknowledge my friends at Newfoundland Power. These cases are tough. I can say I'm happy to see the back of it, but I've nevertheless

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enjoyed it once again before this Board, and I thank you very much for your attention to the submissions that I've made.

CHAIRMAN:

Q. Do you have any -

KELLY, Q.C.:

Q. No, Mr. Chairman, that would be repetitive. I'd simply echo Mr. Johnson's comments at closing. We thank -

COMMISSIONER NEWMAN:

Q. Excuse me, I do actually have a question.

CHAIRMAN:

Q. Oh, I'm sorry, I beg your pardon.

COMMISSIONER NEWMAN:

Q. Mr. Johnson, I wanted to ask you to provide your position on Dr. Booth's suggestion that the Board could establish an ROE for Newfoundland Power of 8.25 percent for an indefinite period, more in relation to the indefinite period and a certain ROE than it is to the particular number of 8.25?

MR. JOHNSON:

Q. Right. I think that position is borne more out of a finance point of view than it would be borne out of a jurisdictional consideration

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that the Board may wish to weigh, and - because there would be nothing to preclude, I think, a Board - or a utility from making an application to come before the Board to have a cost of equity determined, and for the Board to act on the evidence that was brought before it. So I see where Dr. Booth was driving at, but I don't think that that is a proposal that in the context of the Public Utilities Act that you could solidify a return for five years and then lock it up without review.

COMMISSIONER NEWMAN:

Q. Okay.

(12:33 P.M.)

CHAIRMAN:

Q. I guess if there's nothing further then, we are finito. Thank you all very much and we will have a decision.

(HEARING CONCLUDED)

CERTIFICATE

I, Judy Moss, do hereby that the foregoing is a true and correct transcript of a hearing in the matter of Newfoundland Power Inc.'s General Rate Application heard on the 8th day of February, 2013 at the offices of the Board of Commissioners of Public Utilities, St. John's, Newfoundland and Labrador and was transcribed by me to the best of my ability by means of a sound apparatus.

Dated at St. John's, NL this
12th day of February, 2013
Judy Moss
Discoveries Unlimited Inc.

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